

# Office of City Auditor

## REVIEW OF THE SEATTLE CITY EMPLOYEES' RETIREMENT SYSTEM

SEPTEMBER 18, 2000

**Project Manager:** David G. Jones

City Auditor: Susan Cohen

Deputy City Auditor: David G. Jones

Auditors: Susan Baugh  
Yanira Cuellar  
Eileen Norton  
Linneth Riley-Hall  
Jerry Stein  
Scottie Veinot

Administrative Specialists: Carolyn Yund  
Thyra Brooks

## City of Seattle

700 Fifth Avenue, Suite 4090  
Seattle, Washington 98104-5030

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City of Seattle

Office of City Auditor

Susan Cohen, City Auditor

September 18, 2000

The Honorable Paul Schell  
Seattle City Councilmembers  
City of Seattle  
Seattle, Washington 98104-1876

Dear Mayor Schell and City Councilmembers:

Attached is our report on the Seattle City Employees' Retirement System. The Executive Summary provides a brief discussion of the report's findings and recommendations. We are pleased that the recently appointed Executive Director of the Retirement System has agreed to implement our recommendations.

We appreciate the cooperation received from the staff of the Seattle City Employees' Retirement System during the audit process. If you have any questions regarding this report or would like additional information, please call me at 233-1093, or David Jones at 233-1095. To improve our work, we ask our readers to complete and return the evaluation form at the back of this report.

Sincerely,

Susan Cohen  
City Auditor

Enclosure



Office of City Auditor, 1100 Municipal Building, 600 Fourth Avenue, Seattle, WA 98104-1876

Tel: (206) 233-3801, Fax: (206) 684-0900, TTY: (206) 233-0025,

E-Mail: [auditor@ci.seattle.wa.us](mailto:auditor@ci.seattle.wa.us), Website: <http://www.pan.ci.seattle.wa.us/seattle/audit>

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## **EXECUTIVE SUMMARY**

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### **SUMMARY OF FINDINGS**

The Seattle City Employees' Retirement System (SCERS) can strengthen its management controls related to financial accounting, investment management, and reporting by:

- Establishing formal management control systems.
- Taking steps to ensure that there is sufficient financial, investment, and actuarial oversight of the Executive Director, including appropriate segregation of duties.
- Ensuring SCERS' disclosures and reporting on financial and investment data are accurate and in accordance with Government Finance Officers Association (GFOA) standards.
- Ensuring SCERS' investment consultant is sufficiently independent.

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### **SUMMARY OF RECOMMENDATIONS**

We recommend the following steps for strengthening SCERS:

- SCERS should develop system-wide accounting and investment management standards, and policies and procedures.
- To ensure adequate segregation of duties and better ensure the accuracy of SCERS' financial reports, the City's Treasury Division should perform certain tasks related to the reconciliation of SCERS' investment statements.
- The Retirement Board of Administration should formalize SCERS' management control systems with the Bank of New York, the City's Treasury Division, and SCERS' investment managers.
- SCERS should relieve its current investment consultant of the responsibility for managing SCERS' directed brokerage commission program, and request that the consultant have its system for calculating portfolio rate of return validated by an independent third party.
- SCERS should obtain brokerage commission rebates through a competitive process.
- SCERS should establish a charter for the SCERS' Investment Advisory Committee.
- SCERS should commit more resources to compliance and financial audits.

- SCERS should undergo regular actuarial audits.
- Financial evaluations and actuarial reviews of SCERS should be conducted by independent auditors who are hired by, and report directly to, the SCERS Board of Administration's Treasurer.

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## **RESPONSE OF THE SEATTLE CITY EMPLOYEES RETIREMENT SYSTEM**

SCERS appreciates the Office of City Auditor's recommendations. SCERS will establish priorities, and will be implementing these recommendations to try to make the Retirement System even better and stronger than it is currently is.

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## BACKGROUND

The Seattle City Employees' Retirement System (SCERS) is a City of Seattle department that is responsible for providing retirement benefits to eligible City employees. SCERS has approximately 9,600 active members and 4,700 retired members. All employees who work for the City are eligible to participate in SCERS, except for uniformed members of the Fire and Police Departments. The majority of active members contribute 8.03 percent of their salaries to SCERS while the City provides a contribution currently of 8.03 percent. The system has over \$1.5 billion in assets.

The administration of SCERS is vested by ordinance in a Board of Administration under and pursuant to the direction of the City Council. The Board's seven members include the City's Directors of Personnel and Finance, the Chair of the City Council Finance Committee, three elected members, and one member selected by the other six from the community. The Board appoints an Executive Director to supervise SCERS' day-to-day operations.

The Board recently appointed a new Executive Director after a lengthy recruiting effort. The Assistant Executive Director acted as the Executive Director during the recruiting process. In addition to the executive level positions, SCERS' budget allows for eleven staff positions.

In accordance with state law, SCERS receives investment advice from the appointed members of its Investment Advisory Committee.

SCERS contracts with several firms for professional consulting services. The Bank of New York provides custodial services for securities owned by SCERS; the firm of Milliman & Robertson, Inc., provides actuarial services; Wurts & Associates monitors the performance of SCERS' investments; and a number of professional investment managers are retained to manage SCERS' common stock, real estate, and fixed income holdings.

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## AUDIT SCOPE, OBJECTIVE, AND METHODOLOGY

We decided to perform this work to follow up on a finding reported by the State Auditor's Office in its audit of the City's 1998 activities. The State Auditor reported that SCERS made a year-end journal entry, concerning investments of over \$30 million, without sufficient supporting documentation. We were also influenced by the work we performed for our July 16, 1999 report, Management Review of the City of Seattle's Pension Systems, which indicated that SCERS controlled the vast majority of the City's retirement assets. We believed it would be prudent for our office to conduct a more in-depth review of SCERS given its \$1.5 billion in assets.

During our audit, we examined SCERS' management control systems including accounting, investment, and reporting activities. Our primary objective in auditing

SCERS' control systems was to determine if they were in the best interest of SCERS members.

Our audit methodology consisted of the review of:

- State and City retirement regulations, and industry standards and guidelines;
- SCERS' books and records for 1996-1998;
- Washington State Auditor's Office work papers and SCERS Board and Advisory Committee records;
- The records of SCERS' investment consultant; and
- Information collected from "peer" retirement systems in Boston, Dallas, Houston, Kansas City, Phoenix, Spokane, and Tacoma.

We conducted our work in accordance with generally accepted government auditing standards.

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## FINDINGS

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### **Investment Statement Review and Reconciliation**

During a 1998 audit, the Washington State Auditor's Office found that SCERS made an unsupported \$30 million adjustment, related to investments, to the City's general ledger. We reviewed this finding and performed additional testing. We concluded that the unsupported adjustment was due to inadequate controls and accounting procedures rather than malfeasance. For example, we found that SCERS personnel did not consistently perform a monthly reconciliation of SCERS' investment transactions.

SCERS does not have a formal process for reconciling investment statements and its current process does not maintain adequate segregation of duties. SCERS management receives monthly investment statements for approximately two-thirds of its portfolio from the Bank of New York. For the remaining portion of the portfolio, SCERS management receives quarterly statements from its investment managers. During the period we reviewed, we found that SCERS management, who are responsible for authorizing investments, were either performing the investment statement reconciliations or supplying the information that a SCERS accountant would use to reconcile the statements. To ensure adequate segregation of duties, the persons responsible for authorizing transactions should not be involved with the reconciliation process.

SCERS officials noted that Wurts & Associates prepares a quarterly audit report for SCERS that reconciles the information provided by the Bank of New York with data Wurts obtains from a third party source. SCERS officials also stated that they ask their

investment managers to reconcile their accounts with the reports issued by the Bank of New York. We believe a formal reconciliation process performed by an independent third party would better ensure the accuracy of SCERS' financial reporting. SCERS officials indicated that they were supportive of this suggested improvement.

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### **Calculation of Portfolio Rate of Return and Presentation of Performance Data**

The majority of large public retirement systems, including those we surveyed, use the presentation standards of the Association for Investment Management and Research (AIMR). The Government Finance Officers Association states that a public employee retirement system's Comprehensive Financial Report (CAFR)

should indicate the basis of presentation for the data reported in the investment section. Pension plans are strongly encouraged to present investment information to the greatest degree possible in conformance with the presentation standards of the Association for Investment Management and Research.<sup>1</sup>

SCERS does not adhere to the following AIMR standards:

- Time-weighted rates of return. SCERS used estimates rather than time-weighted rates of return for some of its cash and real estate investments.
- Internal rate of return presented for venture placements (or capital). SCERS did not calculate internal rate of return on its venture placements.
- Independent validation of the system used to calculate portfolio rate of return. The system developed and used by SCERS' consultant (Wurts & Associates) has not been validated by a third party.

If SCERS used AIMR's Performance Presentation Standards, it would provide greater assurance that SCERS' fund performance, including the current year rate of return, was accurately presented.

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### **Rate of Return Calculation**

Because SCERS does not use AIMR standards for reporting fund performance, its members have no assurances that the stated rate of return (15.1 percent in 1998) is correct. For example, SCERS' reported rate of return does not include venture capital partnerships and weighted cash investments.

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<sup>1</sup> Government Finance Officers Association, *Pension CAFRs: Guidelines for the Preparation of a Public Employee Retirement System Comprehensive Annual Report*, 1996, p.29.

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## **Rate of Return Adjusted by Advisory Fees Not Disclosed to Board, Advisory Committees or Members**

SCERS' advisory fees and expenses are not included in its rate of return calculations for equity and fixed income investments.<sup>2</sup> According to one Investment Advisory Committee member, the Committee has requested this data for more than five years. This data provides an important management tool to measure individual fund managers' results within an asset classification. It also facilitates comparisons between active and passive investments.<sup>3</sup> For example: the expense ratio for Vanguard's 500 Index Fund, which is a passive investment fund, is .18 percent. Some SCERS' fund managers use the active management style and charge higher percentages than .18 percent. If an active fund had a 1 percent charge, its performance would have to exceed the Standard & Poor's Corporation's 500 Index by .82 percent to match the performance of a passive investment, such as the Vanguard 500 Index (the 1 percent charged by the active investment manager minus the .18 percent that would be charged by purchasing Vanguard's 500 Index Fund).

Rates of return calculations are one of the more important measures of investment success.<sup>4</sup> Thus, the calculation should be accurate and equitable between investments.

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## **Investment Consulting Contract**

SCERS has retained the same investment-consulting firm (Wurts & Associates) for the last seven years. The consultant's primary duties, for a fixed annual fee, are to prepare a quarterly investment results report and a quarterly audit report that reconciles Bank of New York data with that from a third party source. For additional fees, the consultant evaluates investment alternatives. We noted the following issues regarding SCERS' management of the investment-consulting firm:

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### Payments

SCERS' first contract with the consultant, covering the period from January 1, 1994 through December 31, 1997, stated that the fixed fee for services was \$168,000 payable over sixteen quarters<sup>5</sup>, or \$10,500 per quarter. However, between January 1, 1998 and January 31, 1999, SCERS purchased quarterly services from the consultant without a

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<sup>2</sup> AIMR's new "Global Investment Performance Standards" require a presentation of rate of return with fees and without fees.

<sup>3</sup> Passive investment management, also known as indexing, means investing in exactly the same securities, in the same proportions, as an index such as the S&P 500. The style is considered passive because portfolio managers do not make decisions about which securities to buy and sell; they simply copy the index by purchasing the same securities included in a particular stock or bond market index. The aim of active fund management for a particular fund, after fees are paid, is to outperform the index.

<sup>4</sup> Risk adjusted rate of return being the other important measure.

<sup>5</sup> The firm charges an hourly rate for investment research and evaluation services because they fall outside of the contract's scope.



contract.<sup>6</sup> Furthermore, between January 1, 1995 and December 31, 1998, the consultant billed SCERS \$15,000 per quarter, or \$4,500 per quarter more than the contract specified. According to a SCERS official, these additional payments were for auditing services. SCERS officials provided us with access to the audit reports produced by Wurts, including the initial one that was issued for the first quarter of 1995. They also provided documentation indicating that in February 1994 the SCERS Board approved obtaining the auditing services, but were unable to find any documents that showed the Board authorized the specific amount of a \$4,500 quarterly fee.<sup>7</sup>

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### Informal Directed Brokerage Arrangement

In early 1995, SCERS made an informal arrangement with its investment consultant to establish a directed brokerage payment program. In a directed brokerage program, a broker credits a portion of its commission back to the investor. The broker earns trade commissions through the security transactions (purchases and sales) it conducts. SCERS has used its directed brokerage earnings to pay for some of the services of its investment consultant. SCERS' investment consultant's contract does not mention directed brokerage as a form of payment.

Since it established the program, SCERS has requested that its investment managers direct from 30 to 40 percent of their trades through a specified brokerage firm and broker/dealer, as long as the total transaction costs are competitive with those available through normal brokerage channels (i.e., "best execution"). The brokerage firm rebates 85 percent of the commission to SCERS' investment consultant. The investment consultant keeps 18.3 percent of the rebate and credits SCERS' account with 66.7 percent.

Since SCERS' investment consultant receives over 18 percent of all directed brokerage transactions, the consultant has an incentive to recommend that SCERS use active investments. However, in recent years, passive investments have achieved better rates of return than active ones in certain areas, such as in the domestic equity market.<sup>8</sup> SCERS domestic equity position was 22 percent passive in 1998. According to SCERS officials, SCERS recently terminated its relationship with all four of its large cap domestic equity investment managers who have provided active management of over \$300 million in SCERS funds. SCERS transferred these funds into index accounts that are passive investments.

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<sup>6</sup> SCERS' second contract with Wurts & Associates covers the period of February 1, 1999 through January 31, 2003.

<sup>7</sup> SCERS officials had documents that showed that the Board of Administration approved the \$4,500 quarterly fee for Wurts' custodial audit services for the February 1999-January 2003 contract.

<sup>8</sup> Ninety percent (90 percent) of managed funds did not match the performance of the Standard & Poors 500 Index in 1999.

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## Government Finance Officers Association Guidance

In its discussion of recommended practices for directed brokerage programs, the Government Finance Officers Association (GFOA) states:

Public pension funds require comprehensive annual disclosure of all soft-dollar benefits and services received by all vendors, and that all appropriate requests for proposals (RFPs) for services to the plan and its trustees provide a comparison of soft-dollar services against hard-dollar costs if the plan were to instead direct that commissions be recaptured to the fund. Brokerage costs and arrangements should be reviewed formally on a periodic basis to assure that the net costs of transactions and services are as low as feasible. This can be accomplished internally depending upon available resources or by external professionals, as appropriate.<sup>9</sup>

SCERS' informal arrangement with its investment consultant contradicted the following aspects of GFOA's guidance:

- SCERS made no comprehensive disclosures of benefits and services received from its vendors.<sup>10</sup>
- SCERS did not develop or issue an RFP.
- SCERS did not have its directed brokerage arrangement formally reviewed.
- SCERS did not have its net cost of stock trades formally reviewed or analyzed.<sup>11</sup>

SCERS's Acting Executive Director stated that, in the near future, he plans to issue a Request for Proposal (RFP) for providing the directed brokerage program.

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## **Investment Advisory Committee**

State of Washington regulations require cities with self-managed retirement funds to appoint an Investment Advisory Committee of at least three members who are qualified in the field of investment. SCERS has such a committee consisting of six members that periodically meets jointly with SCERS' Investment Committee. However, the Investment Advisory Committee as currently structured may not be able to comply with the spirit of the regulations to provide the City with expert advice on current and future investments. The Advisory Committee does not have a charter specifying such items as required qualifications for membership and meeting attendance expectations. The table

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<sup>9</sup> GFOA's 1999 recommended practices for directed brokerage programs can be viewed on its web site ([www.gfoa.org](http://www.gfoa.org)).

<sup>10</sup> In its 1998 annual report, the City of Phoenix's Employees Retirement Plan contained information on its directed brokerage program.

<sup>11</sup> A SCERS official stated that the net cost of stock trades are reviewed on an informal basis.

below, which summarizes our review of the minutes for the last eight quarterly meetings, indicates that Advisory Committee member attendance was low.

### **Investment Advisory Committee Member Attendance**

<b>Member</b>	<b>Meetings Attended (out of 8)</b>
# 1	3
# 2	2
# 3	1
# 4	3
# 5	5
# 6	3

State regulations require that the Committee submit an annual report. The Committee made the following four recommendations to SCERS in its 1998 annual report:

- Review the current securities lending program to determine if a superior plan exists.
- Review the current directed brokerage arrangements to determine if a superior program exists.
- Revise the “early warning program” to improve the monitoring process and determine appropriate management responses.
- Revise the format of the Committee’s quarterly meetings to focus on long-term review of risk-adjusted performance.

SCERS implemented the first recommendation. SCERS officials stated that they are working on the other three recommendations.

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### **Adherence to City’s Ethics Policies**

The City’s Code of Ethics prohibits City employees from accepting gifts from vendors because such gifts could influence procurement decisions. SCERS investment contracts commonly exceed \$50 million. Until March 1999, it was SCERS’ policy to accept trips paid for by investment firms because SCERS officials viewed the trips as opportunities to receive free education and “network” with retirement system peers. SCERS officials did not believe that the trips violated the City’s Code of Ethics, based on informal conversations with the City’s Ethics and Elections Commission in 1996. After we discussed this matter with the Ethics and Elections Commission’s Executive Director and SCERS’ Executive Director, all parties agreed that this practice should be discontinued. If SCERS officials determine that further education would help them better perform their duties, we suggest that they identify and allocate funding toward such activities.

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## Document Control

SCERS does not currently have an adequate document control system to help ensure that pertinent documents are retained and easily accessible. Given the complexity of its operations, the possibility of public disclosure requests, and liability concerns, SCERS needs document controls that meet industry standards.

A Government Finance Officer's Association (GFOA) publication identifies record keeping standards recommended for protection from liability. Specifically:

Where possible, pension plan transactions should be in writing or reduced to written summaries. While this may be somewhat cumbersome with items such as investment transactions, the process produces a paper trail for all transactions that will allow for monitoring, oversight, and ascertaining that all necessary and appropriate approvals have been secured.<sup>12</sup>

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## Investment Performance and Actuarial Audits

In a 1999 Pension Research Council study of state and local government pension plans, 86 percent of the plans surveyed indicated that they undergo independent investment performance audits.<sup>13</sup> In addition, GFOA recommends independent investment performance audits of public pension plans. SCERS relies on its investment consultant, Wurts & Associates, to perform certain monitoring and audit functions. However, as explained earlier, Wurts's independence is weakened by its role in the directed brokerage rebate process and through its use of a system for calculating returns on investment that has not been validated by an independent third party. Furthermore, Wurts relied on some investment figures supplied by SCERS management for its 1998 return on investment calculations rather than obtaining them independently. SCERS officials indicated that they are willing to take steps to mitigate these problems. The Acting Executive Director stated that \$50,000 has been included in the SCERS budget for the next two years to hire a Certified Public Accounting firm to perform audit services.<sup>14</sup> He said that SCERS would attempt to hire a firm that has experience with GFOA requirements and public pension systems.

SCERS actuarial audits are conducted by a consultant whose work is directed by the Board of Administration and SCERS' Executive Director. We were unable to obtain information on the percentage of local governments undergoing actuarial audits; however, GFOA recommends an actuarial audit every ten years. The City of Tacoma used the results of a 1998 actuarial audit, which concluded that Tacoma's actuarial

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<sup>12</sup> Government Finance Officers Association, *The Legal Obligations of Public Pension Plan Government Boards and Administrators*, 1997, p. 59.

<sup>13</sup> Pension Research Council of the Wharton School of the University of Pennsylvania, *Developments in State and Local Pension Plans*, 1999, p.33.

<sup>14</sup> SCERS spent \$5,866 for audit services provided by the Washington State Auditor's Office in 1998.

assumptions were too conservative, to evaluate proposed changes to Tacoma's actuarial assumptions.

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## **Other Issues**

We also noted additional areas in which SCERS' management controls could be improved:

Policies and Procedures - SCERS did not have a comprehensive written policies and procedures manual to govern its operations.

Annual Report - SCERS could improve the quality of the information provided in its annual report by including certain items recommended for reporting by the Government Finance Officers Association (GFOA). For example, SCERS does not include a report on its investment activities, an outline of its investment policies, or a list of the largest assets held.

We were pleased that, during the course of our audit, SCERS officials agreed to provide additional disclosure in the next annual report on the costs of the investment monitoring and audit services provided by the System's investment consultant (currently Wurts & Associates).

Wire Transfers - SCERS does not have updated and comprehensive written policies governing wire transfers, which have involved million of dollars. For example, there is no guidance specifying whether wire transfers are the only method investment managers can use to send or receive funds. We also found that the agreement specifying the City officials authorized to initiate and complete wire transfers to and from the Bank of New York was out-of-date.<sup>15</sup> Furthermore, in theory, funds could be mistakenly or inappropriately wired to unauthorized accounts. The Board gives the Executive Director full authority to direct money transfers between the Bank of New York, Treasury, or SCERS' investment managers.

During the course of our review, SCERS officials stated that they have improved the controls over wire transfers. They said they have updated the Bank of New York wire transfer agreement and are preparing a document for signature by the Board of Administration's Secretary that identifies all the places to which SCERS officials can wire funds.

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<sup>15</sup> Since the Seattle Municipal Code states that the City Treasurer is the custodian of retirement fund assets, SCERS must request Treasury to make and receive wire transfers with the Bank of New York, and with its investment managers.

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## RECOMMENDATIONS

We recommend the following steps for strengthening SCERS' management control systems.

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### **Develop System-Wide Accounting and Investment Management Standards, Policies and Procedures**

SCERS should develop comprehensive accounting and investment management standards, policies and procedures. We recommend that SCERS:

- Develop written accounting procedures for its cash receipts, accounts payable, and banking functions.
- Adopt Government Finance Officers Association and Association for Investment Management and Research standards for disclosure and reporting, including those for directed brokerage commission rebates.

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### **The City's Treasury Office Should Perform Tasks Related to the Reconciliation of SCERS' Investment Statement**

To provide sufficient segregation of duties, the City's Treasury Division should perform certain tasks related to the reconciliation of SCERS' investment statement. SCERS' Executive Director and Treasury officials should work together to determine the specifics of the reconciliation process. These reconciliation activities should be performed monthly or quarterly by a qualified, certified public accountant who has no control over the movement of the funds. SCERS Executive Director should instruct the Bank of New York and the investment firms to send copies of their statements directly to the Treasury official performing the reconciliation at the same time they are forwarding the statements to SCERS.

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### **Formalize Internal Control Systems with the Bank of New York, Treasury, and Investment Managers**

The SCERS Board of Administration should send a formal letter to the City's Treasury Division listing the investment managers hired by the City who can receive SCERS funds. In addition, the letter should state that no entity or account, with the exception of Treasury, may receive SCERS funds unless it is on the list. The list should be updated and signed by the Board's chair whenever an investment manager is added to or deleted from the list. In addition, the Bank of New York and the investment managers should be informed that transfers can only be accepted or issued through a wire transfer directed to the City Treasury.

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## **Obtain Brokerage Commission Rebates through a Competitive Process**

SCERS should issue a Request for Proposal (RFP) for a formal directed brokerage program. When it evaluates the proposals, SCERS should include the following two criteria: (1) the number of useful broker-dealers with which the prospective firm has contracts; and (2) the rebate percentage offered by the firm. SCERS' Acting Executive Director stated that SCERS planned to issue an RFP in the near future for the directed brokerage program.

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## **Require Investment Consultant to Give Up Its Role in Directed Brokerage Commission Rebate Process and Adhere to Investment Performance Reporting Standards**

SCERS should ensure that its current investment consultant, Wurts & Associates, terminate its participation in the directed brokerage commission rebate program. The consultant should:

- Be independent and free from conflicts of interest;
- Audit and report on dividend payments;
- Report on investment performance using AIMR Performance Presentation Standards;
- Analyze and report on the directed brokerage program; and
- Provide a report and schedules for SCERS's comprehensive annual financial report.

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## **Set Standards for SCERS' Investment Advisory Committee**

SCERS' Board of Administration should develop a charter for the SCERS Investment Advisory Committee. The charter should include items such as the number of members, required qualifications for members, limits on a member's appointment term, job requirements and expectations (for example: meeting attendance, produce an annual report, etc.); and compensation (for example: lunch and \$100 per diem for each day of work).

In addition, SCERS' responsibility to the committee should be defined in the charter. For example, the charter could specify that SCERS is responsible for formally debating and considering all issues listed in the Committee's Annual Report.

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## **Commit More Resources to Compliance and Financial Audits**

SCERS should commit more resources to independent compliance and financial audits. In addition, consultants hired to perform audits and evaluations of SCERS, as well as actuarial reviews, should be hired by, and report to, the Treasurer of the SCERS Board of

Administration. The results of these audits and evaluations should be provided to each member of the SCERS Board of Administration.

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**Undergo Regular Actuarial Audits**

SCERS should hire an independent actuarial firm to evaluate, on a regularly scheduled basis, the work of SCERS' actuarial consultant. The audit should evaluate the presentations and calculations in the actuarial valuation reports and actuarial assumptions. The results of the actuarial audit report should be included in SCERS' Annual Report.